DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

36 Letters per Year — $75 Annually

Registered with the Securities Exchange Commission

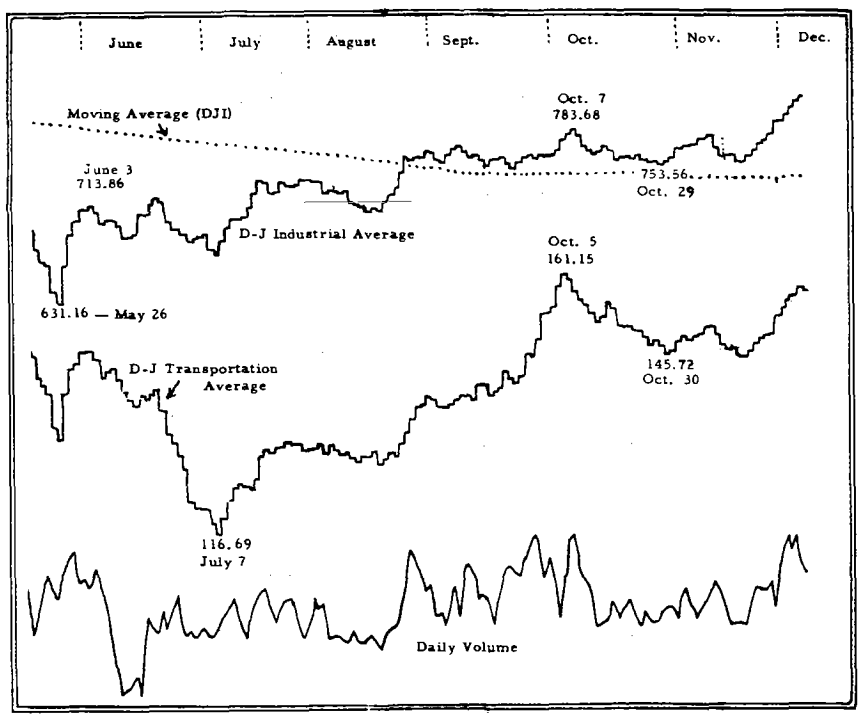
December 9, 1970 Letter 481

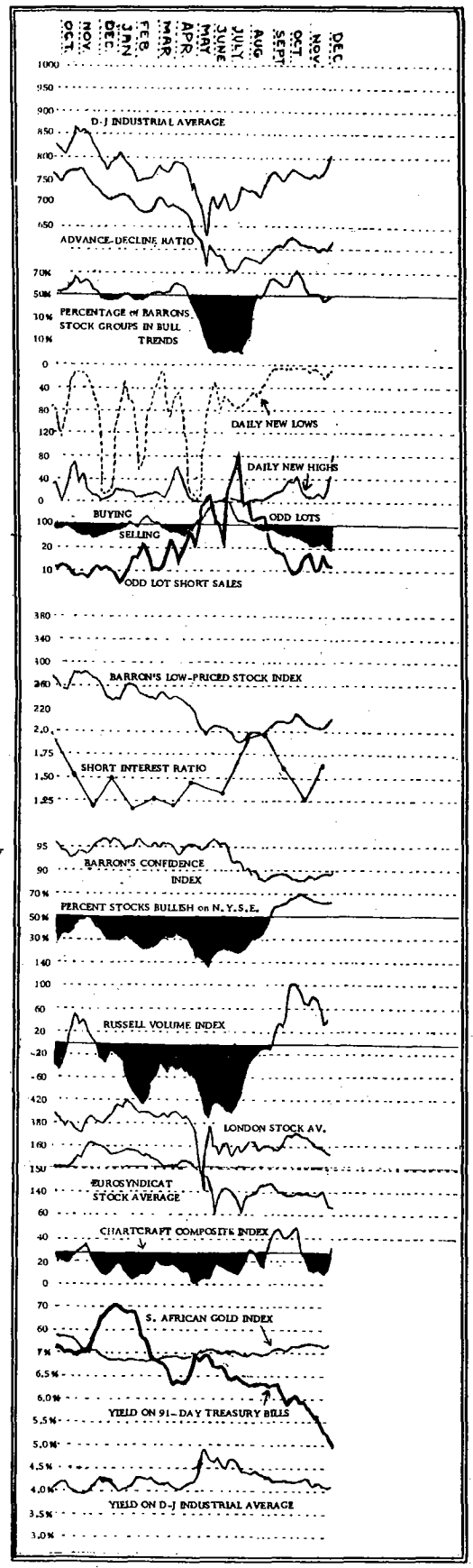
THE MARKET: The really remarkable fact about this bear market (which began in February, 1966) is that during the five years in which it has been in force, it has never succeeded in smashing speculative sentiment. Speculation has been dampened and at times arrested, true, but speculation has never really exited from the Wall Street scene.

Here we are, only seven months after the extreme bear market lows of May, 1970, and we see the market rushing up again on volume of 17 and 20 million shares per day. In another section of this Letter I show that the Low-Priced Stock Index has not yet collapsed in true bear market fashion. Volume at the May, 1970, lows averaged around 9 million shares per day, which was about half the volume which was seen at the old bull market top. Before this bear market is over, I expect Exchange volume to drop 75 to 90% under the old peak volume, which means perhaps 2 to 4 million shares per day.

The reason for the upward correction since May, 26, 1970, was logical enough. Primary bull markets advance and eventually correct (downward), primary bear markets decline and eventually correct (upwards). The correction which began on May 26 was long overdue. But the current speculative extension of the correction can be traced directly to the public's unshakable confidence in the power of the Government plus expectations that the Nixon Administration can and will allow any amount of inflation and monetary expansion between here and 1972 (election time). The real excitement in the rally came after the Federal Reserve Board lowered the discount rate, again firing the belief that all (including Mr. Burns of the Fed) was in hand, specifically in the palm of the hand of a boom-bent Administration.

This leads me to a rather unpleasant (to say the least) conclusion. I am increasingly leaning toward the thesis that this bear market will only enter its final stages with





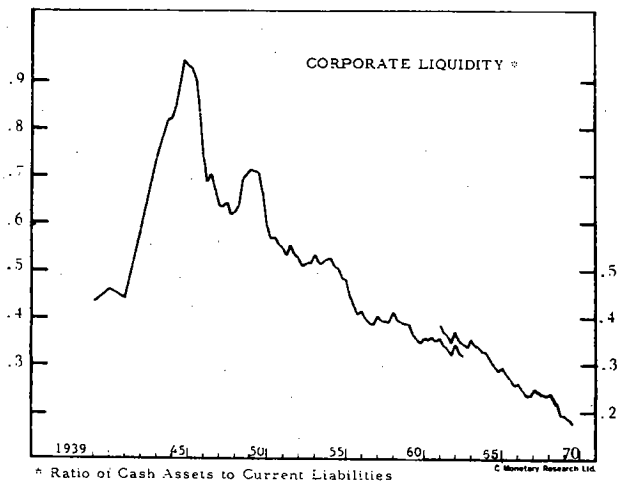
 the collapse, or near-collapse of the Government and the economic structure.

I have no doubt that "technically" this bear market will ultimately end like other major bear markets, with fantastically low prices, an utter dearth of speculation, and a public sentiment which amounts to "There will never be another bull market again." But the way things are going, I am becoming convinced that the factors which will bring on that type of action and bearish sentiment will be a near-collapse of the Government or at least a crumbling of the economic system as we know it.

Today in the California papers the headlines greet us with the message, "California to face a $150 million deficit." Nothing like this has happened in this state since the 1930's. Across the face of the land, deficits are mounting in other states, cities, counties, municipalities. Relief rolls are swelling, medical plans are chewing up state and Federal funds, Social Security costs are leaping, Government costs are sky-rocketing, and in the face of this investors are again attempting frantically to protect themselves against the eroding value of their money.

If corporate earnings were fated to boom over the next few years, I would say that there might be some justification for trying to escape the ravages of inflation by rushing into common stocks. Unfortunately, I see little over the period ahead to suggest anything in the way of a broad, fundamental rise in corporate profits. Economist Eliot Janeway predicts a switch from "profitless prosperity to profitless inflation," and to this I agree.

Nevertheless, despite short-term "plus factors" such as greater infusions of Federal Reserve credit, the long-term problems, far from having been solved, continue to worsen. For instance, in the latest Bank Credit Analyst received here this week, Editor Donald Storey notes that the velocity of demand deposits in New York rose in November to 175.8, well above the 1929 peak of 163. This means that demand deposits are turning over in New York at a rate of better than three times a week, a white-hot velocity which is approaching the point of no return. Mr. Storey also notes that corporate liquidity (see chart) for the first half of 1970 (during which the new issue calendar was at a record high) was at a new low, and it is doubtful whether liquidity has improved much since then (third quarter figures are not yet out).



* Ratio of Cash Assets to Current Liabilities
Source: Securities & Exchange Commission

Thus the economy is tenuously poised between inflation and expanding Fed credit on one side, and a precarious business picture, low liquidity, over-worked bank accounts, damaged profits, declining dividends and rising unemployment on the other side. As things stand, there is no ideal "out" for the economy, and it's only a matter of which side of the ledger improves at the expense of the other. In such a situation, the investor would do well to follow the war-time posture of one of comedian Jonathon Winters' imaginary generals. "Men," announces the general, "don't worry about a thing. Your general will be watching the entire action from atop this hill through a pair of high-powered binoculars."

In the period ahead, there is little doubt that the Administration is going to try "everything in the books" in an attempt to re-stimulate the economy in time for the 1972 elections. That stimulation will undoubtedly take the form of money expansion along with inflation— plus more and more controls. Under these conditions we can expect a continued movement of capital out of the country as harried citizens seek to beat the inroads of inflation.

A recent law requires that Americans report all foreign bank accounts and any export of funds above $5,000. I would expect this amount to drop to perhaps $1,000 in the next year or so with an ultimate ban on any foreign bank accounts or export of funds at all. Americans are, of course, already prohibited from owning real money (i.e., gold), and the 1963 Interest Equalization Tax put an onus on the purchases of foreign stocks. Therefore, I advise subscribers to be prepared for a new list of prohibitions, as the U.S. makes its last ditch stand in an attempt to re-inflate while at the same time prevent Americans from escaping the painful results of its policies.

I will remind subscribers that in world history, there was never a time when a policy of persistent inflation did not result in the collapse of the currency in question, with a resultant massive deflation. This type of monetary anguish usually has led to anarchy or revolution and a tottering or fall of the Government responsible for the destruction of the currency. Many governments have withstood hard times and deflation, the U.S. Government during the 1930's being one of them. But I know of no government which has stood, following a destruction of that nation's money through inflation and erosion of value.

Therefore, as this bear market extends, as the Government attempts to hold off natural corrective forces via routes that lead to further deterioration of the currency, I simply cannot take a short-term optimistic view and say, "Well, hurray, it hasn't happened yet, and here comes 1971." The longer the corrective (primary bear) forces are held back, the worse the ultimate medicine and the more devastating the final collapse which is ultimately fated to arrive.

In the meantime, I realize that the patience of subscribers will be tested over the period ahead. But I know that I am writing to one of the most intelligent groups of people in the nation, and that highly intelligent men tend to be patient men. Therefore, I suggest that my readers continue watching through their "high-powered binoculars," and during the next two or three years those binoculars should witness some of the most dramatic and spectacular financial and monetary events in all history.

As to the near-term market, what I said in the last report still holds true. Last week produced record-breaking volume as the Industrial Average surged above the 800 mark. The Transports, however, have still failed to better their October 5 peak of 161.15. If and when they do, a further extension of this rally in a bear market will be indicated. In the meantime, the greater the volume and the longer the elapsed time without a Transport confirmation, the greater the chances of the rally having seen its final peak.

As a point of interest, the Transports since their July low (116.69) gained more in percentages than Industrials since their May low. Therefore, it cannot be said that they are not capable of making up for lost time on the upside (regardless of current opinions of the entire transportation industry). For this reason, I would watch carefully the 161.15 high in the Transportation Average for indications of whether this advance is headed higher or not.

My own feeling is that as soon as the vacuum created by the GM strike starts to fill (via production and sales), interest rates will start heading upward again, and the bond market will start to decline in earnest. This action could easily put the roof on the stock market rally, preparatory to the next major or primary decline.

SPECULATION: I am including a rather rare semi-logarithmic chart (my own) showing the path of the Dow Industrials and the low-priced stock indices from 1926 to the present (see page 4). The figures from 1926 to 1947 are from Standard & Poor's Low - Priced Stock Index. Barron's L-P Stock Index was used from 1947 to the present (Barron's Index was started in 1946).

In 1958 I wrote my first article for Barron's, and in that article I claimed that despite the 1957 debacle, the stock boom was not over, and in fact a far greater speculative push for the bull market lay ahead. This article produced a great deal of controversy, but it proved to be correct (the controversy stemmed from the fact that the bearishness was so thick you could cut it with a knife during 1958).

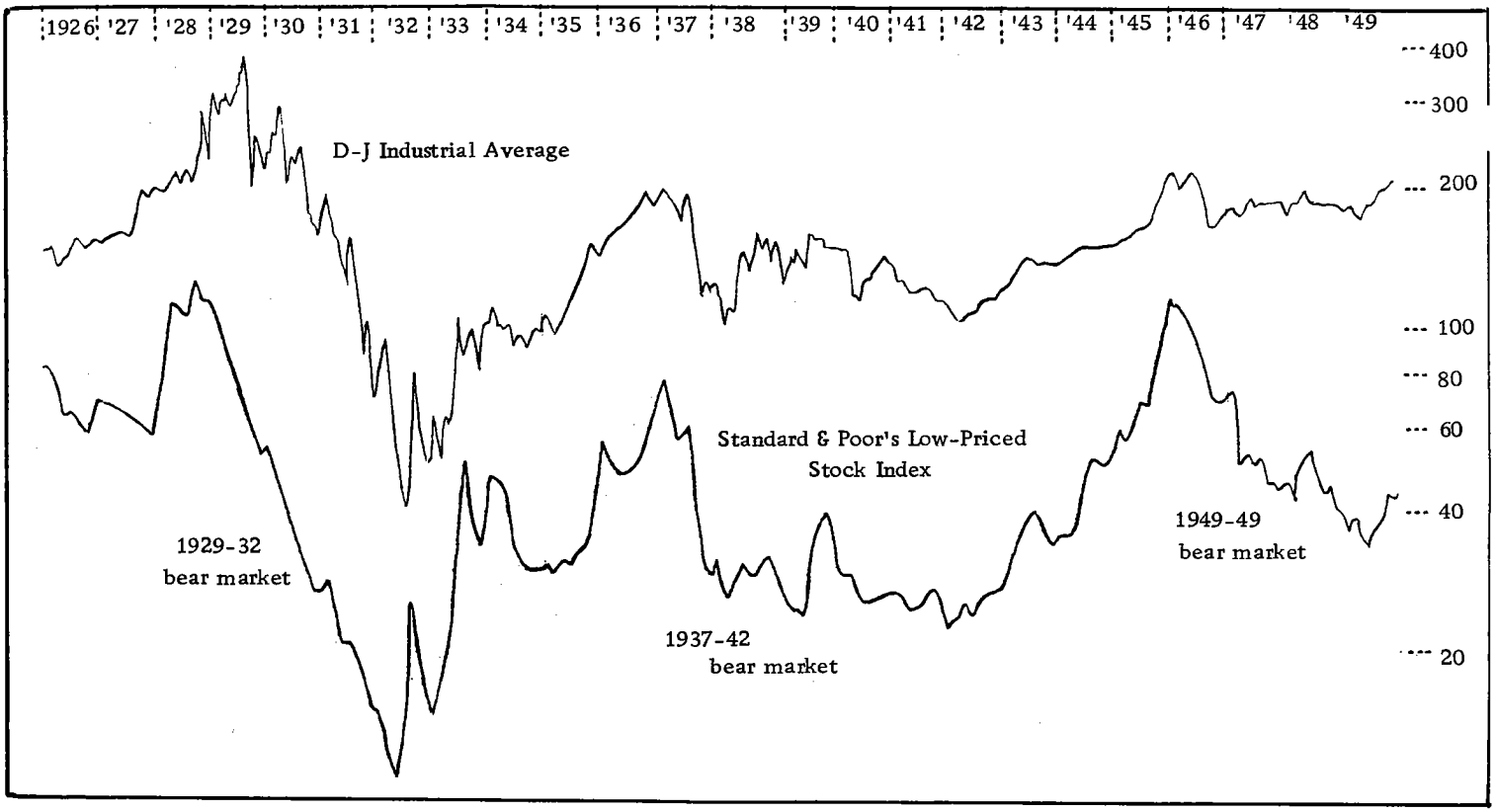
One of the arguments I used for the bull side was that although the Dow in 1958 was far above the old 1946 bull market peak of 212, the L-P Stock Index has never even approached its 1946 high. I noted that the L-P Index was well over 100 at the 1946 peak, but at the 1956, 1957 and 1958 peaks (at which time the Dow was over 500), the L-P Index has never even bettered the 80 mark. Before this bull market breathes its last, I reasoned, the L-P Index should climb far above its old 1946 peak price of around 110.

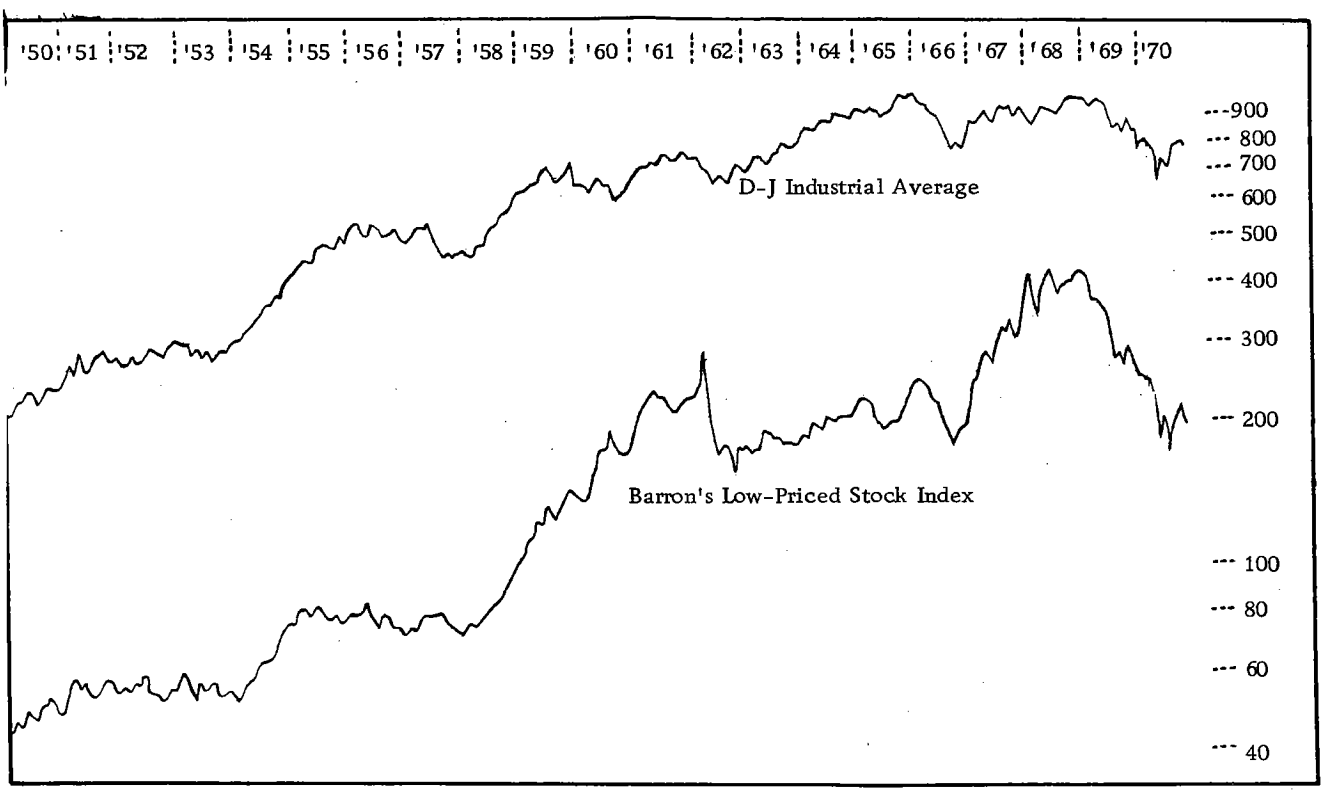
As it happened, the L-P Stock Index boomed during the 1958-62 rise, then rose again in 1968-69 (the latter during the bear market rally). At the 1968 high (December 15) Barron's L-P Stock Index stood at an historic 413.2, better than five times its 1956-58 peak level!

Now comes the reverse reasoning. So far in this primary bear market, the L-P Index has dropped from the 1968 peak of 413.2 to the July, 1970, low of 170.14. This represents a drop of 58% in a period of 20 months. Both in duration and extent, this drop is very sub-standard.

For instance, the 1928-32 collapse in the L-P Index took four years and wiped out over 90% of the value of the L-P Index. The 1937-41 cave-in in the L-P Index lasted four years and wiped out 72% of the L-P Index value. The comparatively mild 1946-49 slide lasted three years and wiped out 70% of the value of the L-P Index.

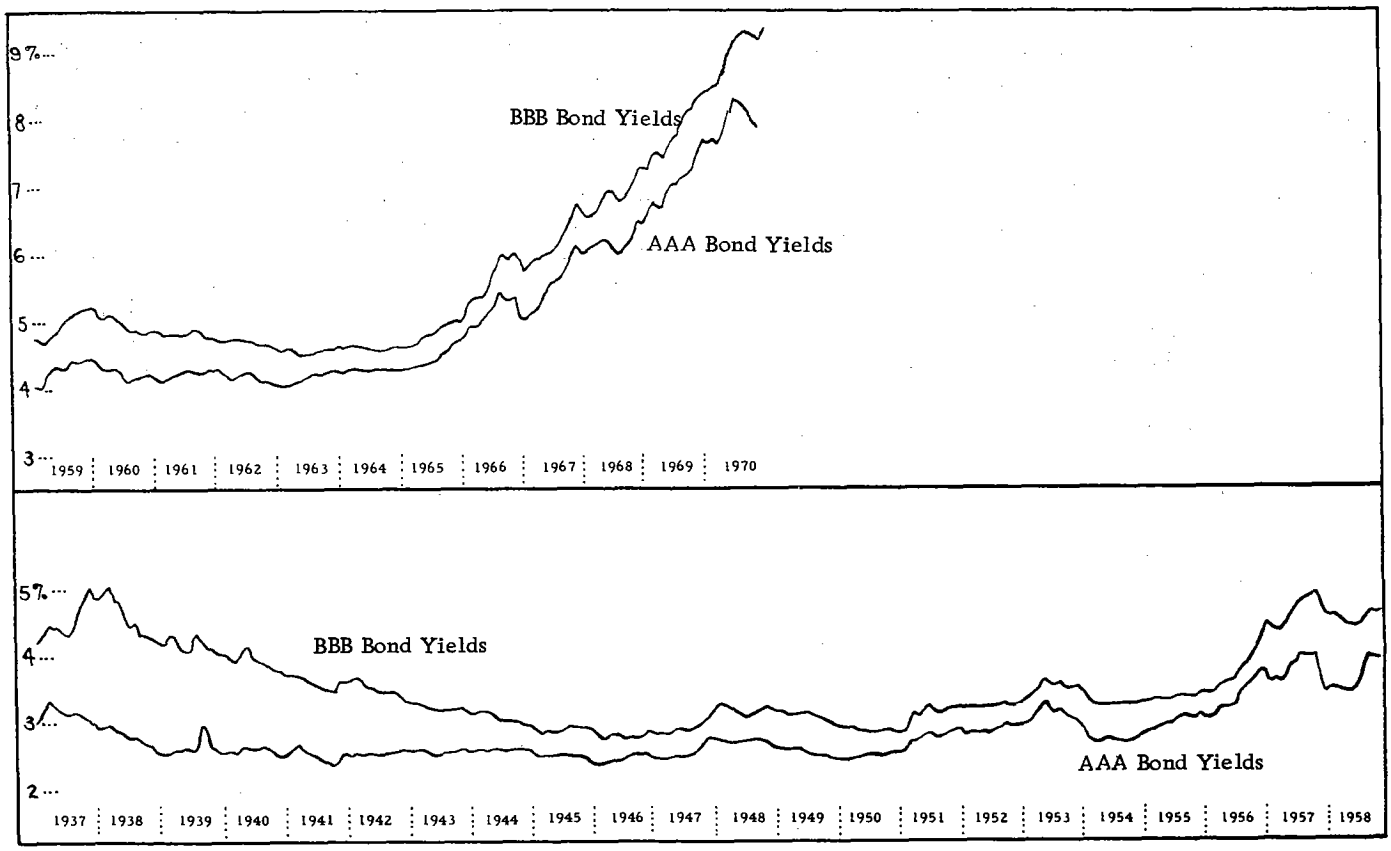
Against those figures, the 20-month drop of late-1968 to July, 1970, wiping out 58% of the L-P Index value, may be considered mild. It suggests to me that this bear market is far from over, and that the collapse in speculation (as gauged by the L-P Stock Index) has much further to go. As a sheer guess, I would say that this bear market should last two or three years longer, and that at its final low we will see Barron's L-P Index in the 50 to 120 zone.





BONDS AND CONFIDENCE: With the collapse in demand for business loans, the bond market has been able to rally. Suddenly, the word is that "Everybody is crazy about bonds." There's only one "fly in the ointment". And that fly is—what kind of bonds?

I am including a chart which was first seen in Letter 466. This chart shows the average yields on Standard & Poor's top-grade or AAA rated bonds and the lesser-grade (but still good) BBB bonds. The chart takes these yields on a monthly basis back to 1937.



What has been happening over the past six months is particularly interesting, and I would say that nothing like it has occurred since 1937. For what we see now is the two yields not only spreading apart — but going in opposite directions. In June the yield on the AAA bonds struck their peak of slightly above 8%. Since then these highest-quality bonds have been advancing, and thereby bringing their yield line down towards the 7.75% level. Had the AAA yields merely dropped faster than the BBB yields, the two indicators would have spread apart. But the dramatic factor is that while AAA yields were dropping, the BBB yields actually rose to a new high. This type of action was last seen during 1937-38, amid one of the most drastic business collapses of the century.

What does the recent action imply? It shows money going into only the highest-grade debt instruments while the lesser-grade bonds act as if there are no takers. When we go down to actual lower quality bonds, interest rates run right up to 12% with many marginal corporations unable to float bond issues at all. This, then, is the essence of the "confidence index" theory, and subscribers will remember that any spread between high-grade and lesser-grade bond yields implies a drop in confidence.

What this chart also implies is that while top-rated corporations may be able to improve their liquidity, the lesser-grade corporations (if they can sell bonds at all) must sell them at record yields, and it is doubtful whether the mass of American corporations can improve liquidity through the avenue of new money via bond issues. I believe it is a very serious situation and one which every subscriber should be well aware of.

TIME BOMB: Europe (even including Britain) is in the grip of inflation-fear. The accompanying clipping on page 6 is the opening paragraph of the Nov. 28 British Economist. I chart the eleven major stock exchanges of the free world. Of the eleven, only the index of Austria appears strong. Britain, Switzerland, Belgium, and France are within a few percentage points of lows for the year. Canada and Italy are following the U. S. in secondary upturns. Most important, the big two, Japan and Germany broke to new 1970 lows last week. Holland and Australia are at new 1970 lows as well.

What is happening? The fight against U. S. -imported inflation is on, and it is going to be a death-struggle. Europe has gone through disastrous inflations in the past; they know that when a currency falls,then a nation tends to follow its currency. Business is slackening in Europe under the pressure of anti-inflationary policies.

Meanwhile, despite a reduction in the German bank rate (to compensate for the U.S. reductions) dollars continue to build in Germany. Despite factory slow-downs in Germany, German reserves are piling up to the tune of almost $13 billion, incredibly only a few billion under U.S. reserves. High interest rates, safety and favorable exports are sucking dollars into Germany, forcing renewed fears of inflation.

The whirl of international manipulations, and the tenuous economic balances which have so far staved off panic are becoming ever more tenuous. The movements of money (despite a growing list of regulations such as the new boost in reserves for U.S. banks holding Eurodollars) is becoming more rapid, more hysterical, more violent.

Inflation in Britain has now taken off frighteningly, with average earnings 14 per cent higher than a year ago and industrial production only 1¼ per cent higher. Consumer prices are so far only 7 per cent up on the year, but a full 1 per cent rise took place in October alone. This is already bringing with it some of the early symptoms of hyper-inflation, including a speeding up of price rises by some businesses to cover next year's expected rises in costs, and a general assumption even by moderate trade unions that they had better pitch their wage claims at over 20 per cent. When an inflation on this scale is stopped, as it has to be eventually, the process is bound to become much more painful the longer it is delayed. The only real question for British economic policy now is how it can be stopped most promptly and effectively.

In the face of this kind of atmosphere, something is "going to give." When it does, confidence, that fragile factor which is holding the world monetary situation together, is going to crumble. No laws, no prohibitions, can stop men from protecting their money, the fruits of their labor. When the value of fiat money deteriorates as it is now doing, governments become tyrannical and men become breakers of laws they don't respect. Morality collapses, and fear and distrust become the order of the day. That's the path we are walking down. The "walk", in fact, has turned into a jog.

The Nixon Administration is now engaging in a policy which is so absurd that it has not even begun to fool the public. Two years ago Mr. Nixon was saying that inflation had to be stopped, and that his Administration would follow the course of honest money. Now, in the face of a gathering slump, the Administration is pulling out all the stops and the battle against inflation has been dropped like a hot penny. If the monetary seams start cracking in 1971, who can say what course our leaders will follow? I can't and neither can you. And neither can the man in the street, who is now so utterly confused that he distrusts everyone.

I read a fascinating piece last week by Mike Royko of the Chicago Daily News. He polled 2500 people on who they would like to lead the Democratic party. He listed the current leaders, Muskie, Kennedy, McGovern and Humphrey. He added the name of Ralph Nader. Here's how they voted. Nader 2005, Muskie 168, Kennedy 62, McGovern 46, Humphrey 15. Wrote Royko, the response to Nader was wildly enthusiastic and one-third of them wrote letters. "Throughout the letters ran a common theme: Nader is honest, Nader cares about ordinary people, Nader won't sell the people out for the good of a political party."

No I'm not suggesting anything about Nader as President. But I'm saying that the people are fed up with dishonesty and lying, they are fed up with inflation and political expediency. The American people are beyond being fooled any more by cynical Government policies. And in view of current Government policies, that's a dangerous mood.

GRUESOME STATISTICS: My friends at Minis & Co. of Savannah, Georgia, put out a "Business Outlook" report once a month. I read their latest report with interest, and I compiled a list of some of their statistics. These figures tell a story on their own and are worth a good deal of study. I show them below. You can make your own comments:

	Change '60 to '65	Change "65 to present
Industrial commodity prices	+1.0%	+15%
Manufactured product prices	+1.7%	+15%
Consumer prices	+7.0%	+24%
Labor-mfg-per hr.	+15.0%	+31%

	1960-64	Cumulative deficit 1965-69	
Bal. of Pay. deficits ($Bils)	$13.9	$11.5	$3.0 (1970, 6 mos.)
Fed. Budget deficits	22.8	37.4	15.0 (1971 est.)

	1960	1965	Latest	Change 1960-65	Change 1965-70
Av. Int. rates, Prime Comm. paper	3.85%	4.38%	6.88%	+14%	+57%
Corp. profits after taxes ($Bils)	$26.7	$46.5	$43.9	+74%	-6%
Unemployment rate	5.5%	4.5%	5.6%	-18%	+24%
Dollar purchasing power (1957-59 equals $1)	$0.97	.91	.73	-6%	-19%